



University of Zurich

Faculty of Law
Fall Semester 2012

Law & Economics

Economic Analysis of Law

Public Law – Public Choice – Political Economy

Prof. Dr. Andreas Heinemann/Dr. Mark Steiner

Slides by Prof. Dr. Rolf H. Weber / Dr. Mark Steiner

Content

- **Theory of state**
 - Philosophical theories
 - Economic theories of state
- Public law – Public choice aspects
 - Election rules
 - Actors in legislative process
 - Division of competencies in governments / federalism

Public Law

Philosophic Theories of State

- **Aristoteles (4th cent. BC,) classicism**
 - „Man is by nature a political animal“
- **Niccolò Machiavelli (15/16th cent.), The power state**
 - „A prince just needs to prevail and to claim his dominion,...“
- **Thomas Hobbes (17th cent.), Leviathan**
 - „Protection from anarchy and insecurity“, „war of all against all“
- **Immanuel Kant (18th cent.), idealistic theory of state, jurisprudence**
 - „...whereby the inhabitants constituted themselves to a state, but actually just the idea of it, after that the legality of the state only can be thought, the original contract, up to which all the people surrender their external freedom to readopt it as a member of a general entity, i.e. of the people regard as state readopt it immediately.“

Content

- Theory of state
 - Philosophical theories
 - **Economic theories of state**
- Public law – Public choice aspects
 - Election rules
 - Actors in legislative process
 - Division of competencies in state

Economic Theory of State Overview

- **The view of the economist**
 - Individual rational utility maximises
 - Market results in Pareto-efficient allocations
- **Requirements?**
 - Coordination (game theory) – Transaction costs
 - Prisoners' dilemma
 - Cooperation – Cooperation costs
 - Public goods
 - Redistribution

Economic Theory of State Prisoners' dilemma

■ Bartering in anarchy?

		Person A	
		Not steal	steal
Person B	Not steal	10, 10	6, 12
	Steal	6, 12	8, 8

■ What happens?

- Stealing is the dominant strategy
- Incentives for defense

Economic Theory of State Coordination

- **Activities under Hobbes' anarchy**
 - Productive (individual and social)
 - Direct production
 - Socially unproductive, individually productive
 - Robbery
 - Defence
- **David Hume, A Treatise of Human Nature (1749)**
 - “Nothing but an increase of riches and possessions could bring men to quit [the state of society without government].”

Economic Theory of State Coordination

Cooperation game without law		A	
		Cooperate	Steal
B	Invest	50, 50	100, -100
	Not invest	0, 0	0, 0

Cooperation game with law		A	
		Cooperate	Steal
B	Invest	50, 50	-50, 50
	Not invest	0, 0	0, 0

Economic Theory of State Coordination

- **Coordination in case of repeated games**

- Signals

- „Tit-for-tat“

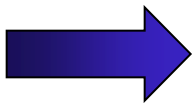
- Obligations

- **Problem: large groups**

- Unknown counterparty

- No repeated games

- High information and und enforcement costs



Collective regulation of coordination through state

Economic Theory of State Coordination

- **Bartering – Gains from trade**
 - Comparative advantages (Ricardo)
 - Specialisation (Smith)
- **Requirements**
 - Property rights
 - Contract law
 - Law enforcement
 - State's monopoly on the use of force
 - Economies of scale on the state's monopoly on the use of force

Economic Theory of State Public Goods

- **Public goods (Samuelson)**
 - Non-rivalry in consumption
 - No principle of exclusivity
- **Typical public goods**
 - National defence
 - Legal certainty / rule of law
 - Competition
 - Freedom (of action, speech, etc.)?
 - Redistribution?
 - Clear air/waters?

Economic Theory of State Redistribution

■ Aristoteles

- „When there is no middle class, and the poor greatly exceed in number, troubles arise, and the state soon becomes to an end“

■ Friedrich Engels

- „The state was created to keep the hostility of classes under control ...“

■ Redistribution as insurance

- Irrationality and uncertainty regarding future prospects
- Redistribution as public good => Security

■ Redistribution as fairness standards

- „Dictator-game“ (Eichenberger/Oberholzer-Gee 1997)
- Fairness has social value

Economic Theory of States

State Formation

- Buchanan: Limits of freedom

State of law (social contract)



Invisible hand



Productive state (State of redistribution?)

Decrease of transaction costs



Benefit of bartering



Common advantages ,
collective goods

Problems of the State

- **„Quis custodiet ipsos custodes? (Juvenal 1./2. cent.)**
 - Who watches the watchmen?
- **Principal agent problems**
 - Monitoring costs
 - „Multi-tasking“, „Fuzzy-tasking“
 - Monitorability of the objectives?
- **Fairness**
 - Rules
 - Enforcement

Content

- Theory of state
 - Philosophical theories
 - Economic theories of state
- **Public law – Public choice aspects**
 - Election rules
 - Actors in legislative process
 - Division of competencies in state

Election Rules

■ Unanimity

- Ensures Pareto-criterion
- Problems
 - High costs for decisions
 - Strategic behavior

■ Majorities

- Parteto-criterion, Karldor hicks?
- Optimal majority?
 - Decision costs
 - External costs of (majority) decisions

The Median-Elector Theorem

- **Harold Hotelling (1929)**
 - Representative democracy
 - Candidates – positioning of parties
 - Distribution of preferences
- **Main influences**
 - Competition v. concordance
 - Party system
 - Winning party supplies the government
 - Coalitions
 - Barriers to access and withdrawal
 - Parties or candidates

Rationality and Voter

- **Voting as rational decision, Anthony Downs**
- **$R = P * B + D - C$**
 - B = Individual benefit of the candidate
 - P = Probability to have the distinct vote
 - C = Costs of voting
 - D = Benefit of voting
- **Controversial is D**
 - „Expressive voter“-hypothesis
 - *Why* would anybody vote for someone/something?
 - „Ethical voter“-hypothesis
 - *Who* do you vote for?

Content

- Theory of state
 - Philosophical theories
 - Economic theories of state
- Public law – Public choice aspects
 - Election rules
 - **Actors in legislative process**
 - Division of competencies in state

Actors in Legislative Process: Politicians

- **Politicians as rational utility maximisers**
- **Aim: (Re-)election**
 - Popularity with group of voters
 - Support of lobbies/special interest groups
 - Favouritism of „visible“ legislation
 - Negligence of important, „invisible“ legislation
- **What legal/democratic limitations to influence incentives?**
 - ...?
 - ...?
 - ...?

Actors in Legislative Process: Bureaucrats / Civil Servants

- **Maximisation of benefits of civil servants**
 - Budget
 - Employees
- **Individual benefit v. public good**
 - Maximisation of benefits => too much public goods
- **Limitations: Politicians**
 - Measures of control v. cost of control
 - Too much „visible“ public goods required
- **Problem**
 - No democratic control
 - No competition



High costs

Actors in Legislative Process

Lobbies

- **Size of group**
 - Large groups: Interests are public goods
 - Small groups: easier organisation
- **Rent seeking**
 - Subsidies
 - Tax relief
 - Direct Payments
 - Legislation/Regulation
 - Preference for own interests
 - Disadvantages for competitors

Rent Seeking

- **Economic benefit**

- I.e. natural monopoly
- Licensing by state

- **Wasted resources through**

- Efforts/expenses of potential operators
- Efforts by civil servants in response to operators
- Obstruction of third parties through monopoly and state

Rent Seeking

Regulation in favour or against Consumers?

- **Example: Bridge**
 - Welfare maximizing optimal bridge toll = 0
 - Private bridge operator = Monopoly price
- **Who desires regulation?**
 - Regulatory price between monopoly and perfect competition

	Perfect competition	Monopoly
	Demand/effects	Demand/effects
Producers	positive	negative
Consumers	negative	positive?

The Theory of Economic Regulation (Stigler 1971)

- Demand for regulation of
 - Subsidies
 - Access barriers
 - Beneficial or adverse treatment
 - Advantages for complements
 - Disadvantages for substitutes
 - E.g. Butter producer
 - Disadvantages for producers of margarine
 - Advantage for bakers
 - Price setting, administered prices

The Theory of Economic Regulation

Evidence with three examples (Stigler 1971)

- **Obstruction of competitors**
 - Transport industry
 - Certification of transport companies
- **Smaller interest groups are more effective**
 - Refineries
 - Rates of the smaller are higher
- **Regulation protects interest groups**
 - Licensed v. unlicensed professions
 - Higher income
 - More secure jobs
 - Less people employed by firms

Content

- Theory of state
 - Philosophical theories
 - Economic theories of state
- Public law – Public choice aspects
 - Election rules
 - Actors in legislative process
 - **Division of competencies in state**

Economic Analysis of Constitutional Law

- **Three aspects**

- Unitary state v. federalist state
- Centralised v. decentralised
- Direct v. representative democracy

- **Direct v. representative democracy**

- + Means of control
- + Consideration of the preferences
- -- Transaction costs (population number)
 - Solutions: Random-Selection
 - Modern communication technology

Federalism v. Unitary State

Centralised v. Decentralised

■ Allocation of competencies

- Federal: „bottom up“ => decentralised
- Unitary state: „top down“ => central

Advantages federalism	Disadvantages federalism
Consideration of the preferences / local public goods	Idle returns to scale
Means of control	Information costs
Competition	Spillovers – Transfers
„Happy to experiment“	
Direct democratic possibilities	Time need for decisions?
Distribution of competences – Autonomy	

Federalism

Requirments for the Functionality

- **Basic requirements**
 - Fiscal autonomy
 - Regional administrative voted government
 - Mobility
- **Similar: Club theory**
 - Exit => „Vote with their feet“
 - Voice => Elections, referenda, initiatives etc.
 - Loyalty => Pay
- **Further development: FOCI**